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Building globally competitive cities: The key to Latin American growth

The McKinsey Global Institute

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Building globally competitive cities: The key to Latin American growth

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Preface

Latin America is a bright spot in the postrecession global economy, with growth rebounding strongly in much of the region. But to lengthen today's strides toward recovery into a sustained period of rising prosperity will require the continent to take full advantage of the economic potential of its cities.

The McKinsey Global Institute (MGI) has a history of examining Latin America's economic performance, publishing its first major report on the region, *Latin American productivity*, in June 1994, and its first in-depth assessment of the Brazilian economy, *Productivity: The key to an accelerated development path for Brazil*, in March 1998. Latin America's economic performance is a topic we have revisited periodically. As part of a global 2005 study on the role of multinational companies in industry performance, MGI examined the productivity and growth of four sectors in Brazil and Mexico: automotive, consumer electronics, retail, and retail banking. In 2006, we published an update on Brazil's productivity performance, *How Brazil can grow*.

This report, building on our previous work, introduces a new emphasis on the role that cities play in Latin America's economy. It forms part of MGI's worldwide research into the dynamics of urban economies and is the result of collaboration with McKinsey's Latin America office. The project leadership team consisted of McKinsey directors Heinz-Peter Elstrodt from São Paulo and Andres Cadena from Bogotá, MGI director James Manyika from San Francisco, and McKinsey partner Alberto Chaia from Mexico City. Jaana Remes, an MGI senior fellow based in San Francisco, led the research team, working closely with Alejandra Restrepo, a McKinsey engagement manager from Bogotá. The team consisted of Florencia Ardissone, Borja de Muller Barbat, Aldo Borasino, Alejandra Botero, Felipe Diniz, Roberto Duran, Julian Ferris, Lucia Fiorito, and Melissa Floca. The team appreciates the contributions of Janet Bush, MGI senior editor, and Gina Campbell who provided editorial support; Rebeca Robboy, MGI external communications manager; Julie Philpot, MGI editorial production manager; and graphic design specialist Marisa Carder.

We are grateful for the vital input and support of numerous McKinsey colleagues in Latin America, including Lino Abram, Sergio Balcazar, Juan Bermudez, Pilar Cervantes, Patricia Ellen, Marcus Frank, Rodrigo Hetz, William Jones, Gagan Khurana, Andreas Mirow, Adilson Oliveira, Pablo Ordorica, Francisco Ortega, Clara Pava, Jose Maria Rancaño, Giacomo Rimoldi, Bruno Silva, and Jorge Torres. We would also like to thank McKinsey colleagues around the world for their expertise, including Marco Albani, Shannon Bouton, Benjamin Cheetham, Alejandro Diaz, Jaap de Jong, Henry DePhillips, Michael Lierow, Miguel Payan, Luiz Pires, Henry Ritchie, Betsy Rosenblum, Ken Somers, Sebastian Stern, Carrie Thompson, Ireena Vittal, and Jonathan Woetzel.

Distinguished experts outside McKinsey provided invaluable insights and advice. We would particularly like to thank our academic advisers Daron Acemoglu, Elizabeth and James Killian Professor of Economics at the Massachusetts Institute of Technology; Professor Ricardo Hausmann, Director of the Center for International Development and Professor of the Practice of Economic Development at Harvard University; and Michael Storper, Professor of Urban Planning at the University of California, Los Angeles.

This report contributes to MGI's mission to help global leaders understand the forces transforming the global economy, identify strategic locations, and prepare for the next wave of growth. As with all MGI research, we would like to emphasize that this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

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August 2011

Latin America's cities today

260 million people live in 198 large cities in Latin America

In 2007 these 198 cities generated

$3.6 trillion

of GDP—equal to the GDP of India and Poland combined

The top ten cities have a population of

95 million

. . . with average per capita GDP of

$18,000

. . . and total GDP of

$1.7 trillion

in 2007—30 percent of the region's total

NOTE: All data are for 2007. All GDP, per capita GDP, and GDP growth are measured at purchasing power parity.

. . . and tomorrow

315 million people will live in 198 large cities in Latin America in 2025—more than the population of the United States today

50 million people will enter the potential labor force by 2025—more than the working-age population in France today

65% of Latin America's growth to 2025 will come from 198 large cities

By 2025, 198 large cities will generate GDP growth of

$3.8 trillion—almost three times Spain's total GDP today

198 large cities will have per capita GDP of

$23,000 in 2025—more than the per capita GDP of Portugal in 2007

NOTE: All GDP, per capita GDP, and GDP growth are measured at purchasing power parity.

Executive summary

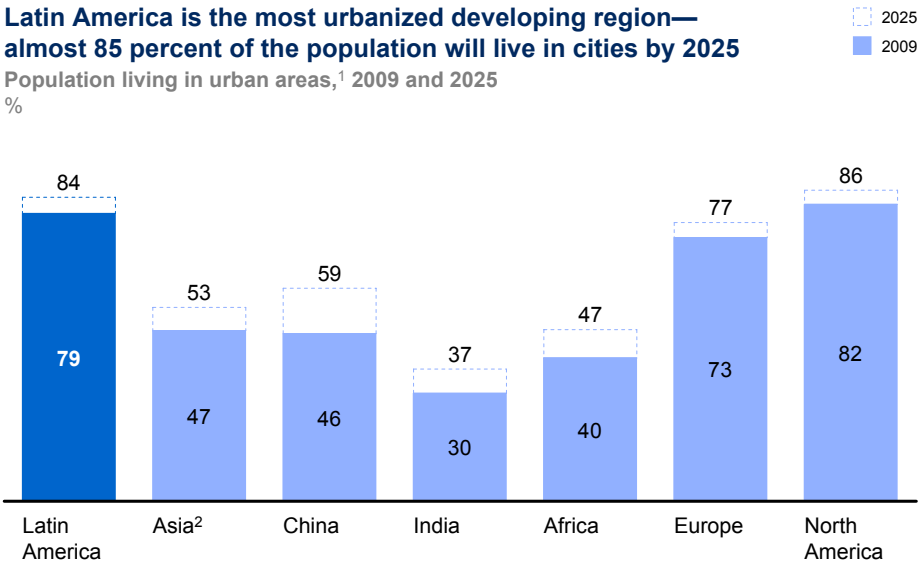
Latin America is more urbanized than any other region in the developing world with 80 percent of its relatively young population living in cities (Exhibit E1). The shift from country to town has contributed much to Latin America's growth, as economies of scale have boosted the productivity of expanding cities and reduced the cost of delivering basic services to their inhabitants.[1] Cities are critical to Latin America's overall economy. The region's 198 large cities—defined as having populations of 200,000 or more—together contribute over 60 percent of GDP today. The ten largest cities alone generate half of that output. Such a concentration of urban economic activity among the largest cities is comparable with the picture in the United States and Western Europe today but is much more concentrated than in any other emerging region. China's top ten cities, for instance, contribute around 20 percent of the nation's GDP.

Exhibit E1

Latin America is the most urbanized developing region—almost 85 percent of the population will live in cities by 2025

Population living in urban areas,[1] 2009 and 2025

%



1 Urban population according to national definitions.
2 Excluding China and India.
SOURCE: United Nations Population Division Department of Economic and Social Affairs, *World population prospects: The 2009 revision*, March 2010; McKinsey Global Institute analysis

The prominence of (particularly large) cities in Latin America's economy makes fulfilling their economic potential a key to sustaining growth in the region as a whole, according to new research by McKinsey & Company's Latin America office and the McKinsey Global Institute (MGI), McKinsey's business and economics research

1 The share of urban population rose from 40 percent in 1950 to 80 percent today as population in cities grew 1.5 times the rate of the region's population growth overall. In contrast, MGI research finds that urbanization will continue to be a major source of growth in China and India, which are in earlier stages in their urbanization. See *Preparing for China's urban billion*, McKinsey Global Institute, February 2009, and *India's urban awakening: Building inclusive cities, sustaining economic growth*, McKinsey Global Institute, April 2010 (www.mckinsey.com/mgi).

arm. Yet Latin America has already won a large share of the easy gains that come from expanding urban populations. Today, many of Latin America's largest cities are grappling with traffic gridlock, housing shortages, and pollution, all symptoms of diseconomies of scale. For the region's largest cities to sustain their growth, they need to be able to address challenges not only to their economic performance but also to the quality of life experienced by their citizens, sustainable resource use, and the strength of their finances and governance. Latin American urban economies need to pay close attention to all four of these dimensions if they are to continue to be the dynamos of the region's growth.

The relative youth of Latin America's population makes transforming its urban economies even more urgent. In marked contrast to the working-age populations in Japan and Western Europe as well as some developing regions, including China and Eastern Europe, Latin America's working-age population is projected to expand continuously until it peaks in the 2040s at around 470 million potential workers. That's 30 percent more than in 2007 and a net increase of 85 million or equivalent to three-quarters of today's labor force in the United States or Western Europe. This offers Latin America a significant potential demographic dividend if its economies can grow sufficiently to generate high-productivity jobs for this large, young workforce—many of them in an urban setting. Employed productively in a dynamic, job-creating economy, young workers could create the wealth on which future investment and sustained growth depend. Conversely, if Latin America's economies do not generate sufficient economic opportunities for this expanding young workforce, difficult social challenges could result.

By the second half of this century, Latin America's demographic profile will look more like Europe's with a shrinking proportion of economically active young people having to provide for a growing share of older people. Unless policy makers, businesses, and civil societies in Latin America take steps now to reform and develop their cities and create more productive jobs in the formal economy, the region runs the risk of growing old before it grows rich.

In order for cities to fulfill their growth potential, broader economic policies need to provide the right incentives for productive, sustainable growth. Past MGI research suggests two priorities: to dismantle long-standing regulatory barriers to productivity and growth in manufacturing and service sectors; and to make better use of the region's natural resources.

WELL-FUNCTIONING CITIES ARE CRITICAL FOR LATIN AMERICA'S GROWTH

Latin America's 198 large cities are expected to generate 65 percent of the region's growth over the next 15 years, MGI estimates. This is equivalent to around 6 percent of projected global GDP growth and is more than 1.5 times the contribution expected from large cities in Western Europe and similar to the contribution anticipated from India's large cities (see Box E1, "MGI has studied three major groups of cities in Latin America").

However, in many of Latin America's top ten cities—the most critical to the economy—the rate of economic growth has declined since the era of rapid urbanization that ran through the 20th century until 1970. Since 1970, growth rates in Brazil's São Paulo and Rio de Janeiro have dropped from above the national average to below the average. Other leading cities in the region have also recently grown more slowly than either their national economies or their midsize peers. For instance, the

Mexico City metropolitan region has posted a slower pace of growth than the average of the nation's 45 middleweight cities, which we define as those with populations of 200,000 to 10 million. (Exhibit E2).

Box E1. MGI has studied three major groups of cities in Latin America

Large cities. We define "large" cities as those with population of 200,000 or more, and we cover all 198 such cities across the region in our analysis. Within this group are four megacities with populations of 10 million or more—Buenos Aires, Mexico City, Rio de Janeiro, and São Paulo. The rest—cities with populations of 200,000 to 10 million—are the middleweights. Our analysis covers entire metropolitan areas, which we name by their core city—in other words, Mexico City and Buenos Aires in this report refer to the broader metropolitan regions that surround (and include) Distrito Federal and the City of Buenos Aires, respectively.[1]

Top ten. This group consists of the ten largest urban areas based on their GDP in 2007. In addition to the four megacities are six urban centers with GDP of $74 billion or more at purchasing power parity (PPP): Bogotá, Brasilia, Caracas, Lima, Monterrey, and Santiago.

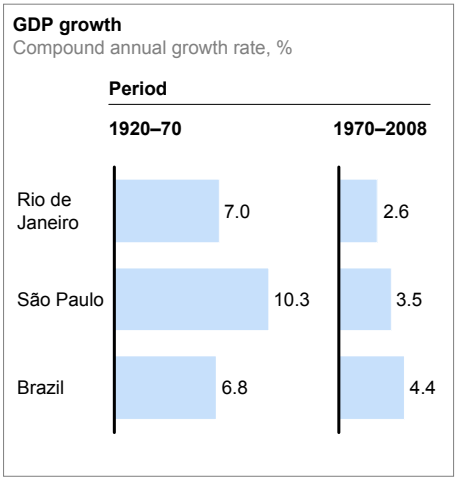
Top 50. This group consists of the largest 50 cities by GDP in 2007—the top ten cities and 40 others. The additional cities are Córdoba and Rosario in Argentina; the 12 Brazilian cities of Baixada Santista, Belo Horizonte, Campinas, Curitiba, Fortaleza, Goiânia, Grande Vitória, Manaus, Norte/Nordeste Catarinense, Pôrto Alegre, Recife, and Salvador; Gran Concepción in Chile; Cali and Medellín in Colombia; San José de Costa Rica in Costa Rica; Havana in Cuba; Santo Domingo in Dominican Republic; Guayaquil and Quito in Ecuador; San Salvador in El Salvador; the 11 Mexican cities of Ciudad Juárez, Guadalajara, León, Puebla, Querétaro, Reynosa-Río Bravo, Saltillo, Tijuana, Toluca, Torreón, and Veracruz; Panama City in Panamá; Montevideo in Uruguay; and Barquisimeto, Maracaibo, Maracay, and Nueva Valencia del Rey in Venezuela.

1 A metropolitan area is a region consisting of a populous urban core (the main city) plus surrounding territory that is socioeconomically linked to the urban core through commuting.

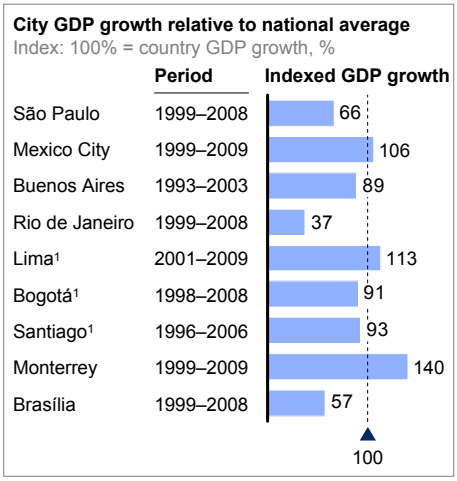
Exhibit E2

The growth of Latin America's largest cities no longer exceeds that of the rest of the region's economy

The relative growth of São Paulo and Rio de Janeiro have declined in the recent past



Most of the top ten cities have grown more slowly than their host economy



1 In cases where GDP data were not available at the city level but the city represented most of the region/province, we used data at this next level.

SOURCE: National and local statistical offices; McKinsey Global Institute Cityscope 1.1

Many of the top ten cities in the region have started to run up against constraints as urban management struggles to keep pace with the demands of expanding metropolitan regions that have "swallowed up" smaller towns that neighbor them but are outside their jurisdiction. The fragmented political boundaries that have resulted have often spread urban management responsibilities, such as for housing or economic development, among mayors and officials in multiple municipalities, state governments, and federal institutions. Planning and policy have often been uncoordinated and funding insufficient to meet growing needs. Many cities have outgrown the capacity of their infrastructure, the design of their transportation systems, and their ability to deliver adequate public services, making it difficult to "get things done" efficiently and effectively. As a result, cities are not generating enough high-productivity jobs to employ an expanding labor force, boosting informal economic activity to damagingly high levels.[2] Unless the largest cities significantly enhance the productivity and number of jobs they generate in the formal economy and boost the efficiency of their operations and management, MGI expects their growth rates to remain below the average for the region's midsize cities—and potentially drag down Latin America's overall rate of growth.

THE REGION NEEDS TO UPGRADE ITS LARGEST CITIES AND HELP MIDSIZE CITIES TO GROW

Latin America's political and business leaders need to act decisively on two fronts to improve the performance of the region's cities and turn its demographic profile to advantage. They need to reform and upgrade the region's largest cities and to enable a broader group of high-performing midsize cities to emerge.

Reforming and upgrading the region's largest cities

To understand how Latin America's largest cities might improve their performance, MGI has assessed performance in eight of the top ten cities (in descending order of GDP): São Paulo, Mexico City, Buenos Aires, Rio de Janeiro, Lima, Bogotá, Santiago, and Monterrey. The assessment is based on 100 quantitative indicators along the four dimensions that interact to deliver sustained urban economic growth: economic performance, social conditions, sustainable resource use, and finance and governance. MGI has collated the results of this analysis in an Urban Performance Index (UPI), a proprietary benchmarking tool designed to compare the performance of cities on detailed—and actionable—metrics.

Many Latin American cities lag behind cities around the world and in their region on these four dimensions (Exhibit E3). For example, Bogotá trails its regional peers particularly in its economic performance. Monterrey performs relatively strongly across all dimensions except sustainable resource use.

But our analysis also finds some examples of promising performance among the top cities. In Mexico, the technology cluster around the Monterrey System of Technology and Higher Education has strengthened collaboration between academia and business. More broadly, Monterrey's per capita GDP grew 40 percent faster than Mexico's between 1999 and 2009, and the city also has the lowest share of population living below the poverty line (4 percent) in the region. Buenos Aires and Bogotá stand out in health services. In each of these cities, more than 90 percent

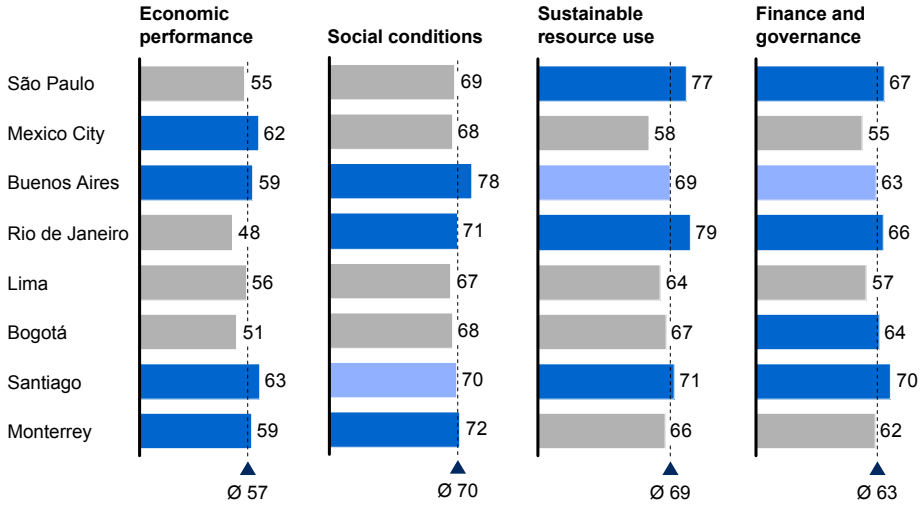
2 The region's regulatory environment, including inflexible labor regulations and costly red tape, also contributes to the region's high rate of informality. See *How Brazil can grow*, McKinsey Global Institute, December 2006; *New horizons: Multinational company investment in developing economies*, McKinsey Global Institute, October 2003 (www.mckinsey.com/mgi).

of the population has health coverage, which is higher than the 85 percent share of New Yorkers with health coverage. In telecommunications, Buenos Aires not only is the regional leader in mobile penetration—at 112 percent—but also has a higher score on this metric than the average of our four international benchmark cities. There are many examples of high performance in some of Latin America's largest cities on measures that are critical to their future growth. This offers an opportunity for others to follow suit.

Exhibit E3

Latin American cities perform poorly against international benchmarks

Index: Benchmark[1] = 100



1 Benchmark defined for each measure as the average of Helsinki, New York, Singapore, and Toronto.
SOURCE: McKinsey Urban Performance Index

Enabling the growth and competitiveness of midsize cities

Alongside Latin America's largest cities, a broad base of high-growth midsize cities has emerged. Today, 188 middleweight cities account for almost one-third of the region's GDP and are likely to generate almost 40 percent of the region's GDP growth to 2025. These cities now lag behind Latin America's largest urban centers in per capita GDP. However, the region's faster-growing midsize cities are likely to narrow that gap by 2025.

Middleweight cities that can provide an efficient environment attractive to businesses and to skilled workers will not only boost their growth significantly but could also become the model for a better designed and more sustainable urban future for Latin America. Promising examples of midsize cities introducing innovative policy and management include Panama City, Viña del Mar in Chile, Curitiba and Florianópolis in Brazil, Toluca and Mérida in Mexico, and Medellín in Colombia.

SEIZING THE URBAN DEMOGRAPHIC ADVANTAGE IN CITIES

Each city in Latin America faces its own distinct set of challenges and priorities, depending on its starting point. MGI has drawn on tried and tested success stories from the region and around the world to identify tangible actions that the region's city leaders could take to address the highest-priority issues they face. McKinsey's experience shows that effective policies can turn around a city's fortunes in as little as ten years. If the number and productivity of urban jobs improve in cities of all sizes, Latin America's young population can help to fuel growth in the long term.

□ □ □

This report is a call to mayors, policy makers, and business and civic leaders across Latin America to join forces and take action to make their cities powerful engines for growth. We hope that this analysis and its underlying data and analytic tools will help mayors and policy makers to diagnose any shortcomings in urban performance, provide actionable examples of how they might overcome current underperformance, and suggest appropriate goals and metrics that would allow city leaders to track progress toward superior performance. It is also our aspiration that our work can help enable companies to better position themselves for the evolving economic opportunities in urban consumer and business segments. Chapter 1 explains the prominence of large cities in Latin America's economy and the need to develop their economic potential. Chapter 2 examines the multiple challenges that Latin America's largest cities must address to fulfill that potential. The final chapter offers some thoughts on an agenda for urban renewal.

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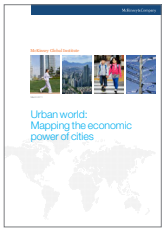


Urban world: Mapping the economic power of cities (March 2011)

Six hundred cities—the City 600—are projected to generate more than 60 percent of global growth to 2025. Within this group, companies need to adjust their strategy to include the 577 fast-growing "middleweight cities" with populations under 10 million. Moreover, nearly half of global growth from 2007 to 2025 will come from 443 emerging-region cities in the City 600, as urban economic power moves south and, even more decisively, east. Middleweights in these regions alone will contribute an estimated 40 percent of global growth.

Beyond austerity: A path to economic growth and renewal in Europe (October 2010)

With multiple pressures on growth and constrained public finances, Europe needs structural reform even to match past GDP growth rates. Parts of Europe have begun to reform with demonstrable success. If the rest of Europe emulated their best practice, the region could add 4 to 11 percent to per capita GDP, without cutting holidays and leave.

Lions on the move: The progress and potential of African economies (June 2010)

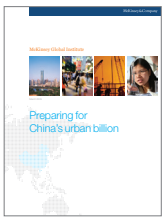
Africa's economic growth is creating substantial new business opportunities that are often overlooked by global companies. Consumer-facing industries, resources, agriculture, and infrastructure together could generate as much as $2.6 trillion in revenue annually by 2020, or $1 trillion more than today.

India's urban awakening: Building inclusive cities, sustaining economic growth (April 2010)

India's lack of effective policies to manage its rapid and large-scale urbanization could jeopardize the nation's growth trajectory. But if India pursues a new operating model for its cities, it could add as much as 1 to 1.5 percent to annual GDP growth, bringing the economy near to the double-digit growth to which the government aspires.

How to compete and grow: A sector guide to policy (March 2010)

Drawing on industry case studies from around the world, MGI analyzes policies and regulations that have succeeded and those that have failed in fostering economic growth and competitiveness at the sector level. What emerge are some surprising findings that run counter to the way many policy makers are thinking about the task at hand.



Preparing for China's urban billion (February 2009)

By pursuing a more concentrated urbanization path guided by action to boost urban productivity, China's local and national policy leaders could minimize the pressures and maximize the economic benefits of urban expansion. A two-part report details the scale, pace, and global implications of urbanization at the sector and city levels.

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